United Nations Industrial Development Organization

Distr.
LIMITED

ID/WG.492/6
18 August 1989

ORIGINAL: ENGLISH

First Consultation on Small- and Medium-Scale Enterprises including Co-operatives

Bari, Italy, 9-13 October 1989

ISSUE 3: FINANCING OF SMALL- AND MEDIUM-SCALE ENTERPRISES*

Discussion paper

Prepared by
the UNIDO Secretariat

* This document has not been edited.

V.89-58632

1. It is generally acknowledged that in developing countries and to some extent in industrialized countries, enterprises of a small and medium scale have limited access to financial sources from banks and other finance institutions.

2. The financial requirements needed to start up enterprises vary considerably with the size of the enterprise, such as micro-enterprises, small-scale enterprises and medium-scale enterprises.

3. The capital needed to start a micro-enterprise is very small and is usually in the range of US$100 to US$300. This group of entrepreneurs totally lacks access to institutional finance. Capital requirements are usually met from personal or family savings. If the amounts extend beyond their own means, this group is often forced to make use of the informal credit market, such as money lenders, middlemen etc., who often offer their services together with other commercial functions (materials, sales etc.).

4. The next larger group, small-scale enterprises and particularly small-scale industries, has higher fund requirements. The amounts needed to start an enterprise of this size are normally not within the range of their savings nor those within the family. Access to financial institutions is of crucial importance to them and applies to funds of fixed capital such as investments in buildings, machinery and equipment as well as for sources of working capital to operate the business.

5. The same situation exists for the medium-scale enterprises when first starting up. A higher amount of funds would open up possibilities to qualify for loan application to development banks instead of commercial banks.

6. The reason for the difficulties of access of small- and medium-scale enterprises to institutional finance is manifold and is fairly well known. Problems are found on both sides - the banking system, including development banks on the one side, and the small- and medium-scale enterprises on the other.

7. They may be categorized as follows:

(a) Lending to small- and medium-scale enterprises is perceived as being risky. The uncertainties faced by a small enterprise, high failure rate, susceptibility to market changes, and their sensibility to any economic fluctuations make the banking sector reluctant to enter into business with clients of the sector. However, most records seem to show that small enterprises are no less creditworthy than those of the larger scale. The smaller the loan, the better the repayments made, a fact which is noticed in lending schemes for small and micro-enterprises. Although small- and medium-scale businessmen may take greater pains to keep within their repayment commitments in order to maintain their creditworthiness, these enterprises usually depend on a single owner which makes them more vulnerable than in the case of a larger enterprise.

(b) On the part of the small- and medium-scale enterprises there is reluctancy to obtain loans from banks. The administrative requirements and formalities to acquire bank finance, particularly the time and paper work involved, are the practical obstacles encountered by most small businesses. Moreover, small- and medium-scale enterprises are unable or unwilling to present full accounting records and other documentation called for by the banks. In many cases such records do not exist, making appraisal of loan

applications difficult and cumbersome. At the same time, small enterprises usually face difficulties in providing collateral or other security demanded by lending institutions before approving loans.

(c) Another obstacle for bank lending to the small- and medium-scale enterprise sector is the high administrative costs of such small loans even if the interest rates applied are based on commercial rates. These high costs affect not only the profitability of the loan scheme to small- and medium-scale enterprises but the entire profitability of the bank. This is a known factor and has been proven in studies undertaken by the World Bank in which administrative costs for handling larger loans were of the order of 0.3 per cent to 0.5 per cent of the costs of the loan, whereas those for small loans were in the range of 2.6 per cent to 2.7 per cent. In addition to those costs, one has to take into account the risk and potential losses. Although small-scale entrepreneurs try to build up or maintain their creditworthiness, it is a fact that many small enterprise loan schemes, especially the earlier ones, have operated with a high level of arrears and defaults.

8. The above-mentioned difficulties and problems are well known on the lending as well as on the receiving side. However, efforts should be made to reduce the effects of some of them and to find a workable solution to channel more funds into the small- and medium-scale enterprise through the institutional credit system for the benefit of the banking sector as well as the small- and medium-scale enterprise.

9. Although financing is possibly the most important requirement for a balanced development of the small- and medium-scale enterprise sector, it should not be seen in isolation of other measures. Any scheme to ease the flow of funds to the small- and medium-scale enterprise sector and to enable small- and medium-scale enterprise units to obtain their loans at favourable conditions should be developed against the background of the entire institutional network provided for the use of small entrepreneurs. A well prepared feasibility study is one requirement, the other is that the extension services and supervised loan schemes will add to building up and maintaining viable projects which will in turn be profitable and enable repayment of the loans granted.

10. Well functioning co-operation between the development institutes together with the non-finance institutes on the one side and the finance or banking sector on the other will be an indispensible prerequisite for a climate and environment conducive to sound growth of small- and medium-scale enterprises.

Policies and operational measures to improve access to institutional finance

11. Policies and operational measures of the finance sector designed for the small- and medium-scale enterprise should form an integral part of the developmental strategy and environment of the sector. They should not only meet the demand and requirements of the banking system, but also those of the clients, taking into account difficulties and problems in obtaining financial resources for:

- investment capital;
- working capital;
- equity participation;
- venture capital;
- funds for micro-enterprises.

12. Attempts have been made to solve the problem of how to provide more institutional finance for small- and medium-scale enterprises through the creation of separate financial institutions to serve exclusively this group of enterprises. The main objectives of these specialized institutes are not to be profitable as a banking institute, but to act as a promotion agent for their special group of clients. Naturally, the major shareholder needs to be the government, since in the first instance the private sector looks at the profitability of its activities. These special banks operate under the supervision and with managerial influence of the government. There are some good examples of such institutes in Europe, Asia and Latin America. Some provide, together with the funds, other services such as training, extension services or general counselling. Their lending schemes operate on concessionary bases, some of them on interest rates lower than the commercial rate and some of them on special conditions as regards security for their loans.

13. It is clear that the operation of such specialized institutions for servicing a specific sector on concessional terms and with high transaction costs for small loans must have difficulties in operating at a profit. The higher risks of the small loans may add to these difficulties and in some cases have affected the institutes' financial solvency.

14. Many such institutes operate fairly well, but all of them have the tendency to open up their group of clients towards larger loans to larger enterprises in order to improve the profitability of the operations or to avoid losses.

15. This type of institution will increase the flow of funds to the small- and medium-scale enterprise sector, but will have to depend on low-cost funds in order to gain profit or at least not to lose. Such low-cost funds have to come from government resources or from external donors. Naturally, the government has to make provision for a continuous flow of such funds and has to cover the losses if they occur.

16. Other instruments to make more funds available to the small- and medium-scale enterprise sector are the development banks or the development finance institutions. Development banks have not been created to maximize profitability but for developmental aspects. In this way they are based on the same rules as the specialized institutions mentioned above. However, the difference lies in the clientele they serve. Development banks do not have the limitation of one selected sector but normally cover the countries' requirements of developmental finance in all sectors of the economy. This might be industry, agriculture, tourism, infrastructural facilities etc. The loans granted are definitely of larger amounts.

17. However, development banks have not always been the most suitable source of finance for small- and medium-scale enterprises for the following reasons. Development banks tend to favour large loans because of lower operational costs which has a positive influence on their profitability. Some of them even have a lower limit of loans which prevents them handling loans below certain amounts. Normally development banks provide funds for investment purposes only and do not cover working capital loans - an important requirement of the small- and medium-scale enterprise; small- and medium-scale enterprises cannot, therefore, obtain their financial needs from one single institution. Moreover, development banks apply an appraisal system for their projects which suits large-scale loans and require data and documentation which go far beyond the capacities as well as the needs of

small- and medium-scale enterprises. This appraisal system results in long time-spans between application and issuance of loans which is not in the interest of the small-scale client.

18. There are a number of cases in which development banks have established special branches or departments dealing with small- and medium-scale enterprise clients or created subsidiary agents even operating a network of offices to cover their smaller clients in the different regions of the countries with finance, and also with other commercial services such as book-keeping, cost calculations etc.

19. Because of the mix of large loans with low operating costs and the small percentage of small loans having high operating costs, there is an "internal subsidy" in favour of the small- and medium-scale enterprise sector which only to some extent redresses the profitability of development banks.

20. Commercial banks, as already stated, are generally or initially reluctant to grant loans to small- and medium-scale enterprises because of the perceived risks and higher operational costs of small loans. They have, however, a number of advantages to act as channels for lending to small- and medium-scale enterprises and are able to offer:

- investment as well as working capital loans;
- other banking services;
- a network of branch offices in different parts of the country allowing close proximity to the client and knowledge of his standing within the community;
- a quick and less bureacratic response to the needs of the entrepreneurs.

21. In their efforts to involve the commercial banking system in increasing the flow of funds to the small- and medium-scale enterprise sector, governments have developed measures focussing on a reduction of risk to compensate for high handling costs. Credit guarantee schemes enable the commercial bank to share repayment risks with the government. Re-financing schemes provide additional funds to the commercial banks. Loans granted to small clients are re-financed or re-discounted by the central bank. Both schemes are of an incentive nature. Schemes putting pressure on commercial banks, such as fixed lending quotas to the small- and medium-scale enterprise sector, did often not achieve the expected result.

22. An important policy element in lending to the small enterprise sector has been the interest rate. Early financing schemes charged lower interest rates to the small- and medium-scale enterprise. This was normal practice and the lower interest rate was seen as an additional incentive. It has, however, led to distortions. Funds have been given to those applicants with good connections, but failed to reach those who could put them into effective use. Moreover, subsidized interest rates led to erosion of original funds and prevented relending or operation of a revolving fund. Continuous lending activities at subsidized interest rates generate a constant demand of additional sources to replenish the fund.

23. A lesson of experience is that the time to make funds available is much more important to the entrepreneur than the rate of interest. A quick decision on a loan application and the immediate release of the funds after completion of all formalities will be by far more beneficial for the operation of the enterprise than a slightly lower interest rate. An alternative to the entrepreneur would be the money lender or the middlemen who demand much higher rates, but who release the funds immediately.

24. Most loans for investment capital are used to purchase imported equipment and machinery. Foreign exchange is required and the problem arises as to who should bear the foreign exchange risk, the entrepreneurs, the banks or institutions lending the funds, or the central bank or the government. Almost all loans in foreign exchange are channelled through the government and the respective central bank or development bank. Since the government through the central bank is in charge of determining the exchange rate of the local currency vis-à-vis the different currencies, the foreign exchange risk should not be left to the entrepreneur; the more so, since the goods produced by the imported machines are in most cases meant for the local market and do not as such fetch foreign exchange. Leaving the foreign exchange risk with small- and medium-scale enterprises would be an additional burden.

25. One important principle of lending funds to small- and medium-scale enterprises is that entrepreneurs should never get the entire project on an 100 per cent loan basis. Even if the entrepreneur and his team are well qualified for the project and the product to be manufactured is of great importance, economically or otherwise for the country, a part of the financial resources, even if it is very small, should come from the entrepreneur. It could be the working capital only or parts thereof. The principle should be applied to have financial participation of the entrepreneur in the project just to keep his interest in successful operation of the venture.

26. Provision of funds to micro-enterprises which are considered part of the small- and medium-scale enterprise sector requires different measures and lending channels. Micro-enterprises have neither a bank account nor any security to offer and the amounts required are small and repayment durations short. In addition, the clients often operate in remote areas far away from the metropolitan area or larger towns. To reach the clients in their locations and their demands for amounts as low as US$200 create the necessity to use different measures. Successful results have been achieved in using unconventional intermediaries such as co-operatives, associations or religious-related organizations as distribution channels for the small funds as well as for debt collections. Security for these small amounts has often been solved by accepting orders, materials etc. as collateral or based on the person's character and his or her position in the society.

Effective implementation of lending policies

27. Policies, rules and operational measures to improve the flow of funds to the small- and medium-scale enterprise sector do not automatically create an increased flow of capital to the sector. It is only the effective implementation of the policies which achieves the results. Rules and measures are developed for a certain sector within a given economic situation and at a specific time. They are made to achieve an intended result for the target group. Since the small- and medium-scale enterprise sector is an inhomogeneous group, one should see if the expected reaction is forthcoming from all parts of the sector. For example, some measures may be well received by industrial units, but less from the trading sector, or the larger units within the sector's benefit; thus the lower end of the group is unable to gain any benefit.

28. Credit guarantee schemes have been developed and put into force, but the commercial banks do not believe in them and react reluctantly. Therefore, it is compulsory, in achieving good results, that policy matters established be screened at periodical intervals and their reaction within the target group analyzed. Developments in the small- and medium-scale enterprise sector and

trends in the entire economy, internal or external, may result in changes in requirement and need. Subsequently, measures should be amended to focus on practical and realistic problems of the sector and result in the intended reactions and results.

Special windows for small- and medium-scale enterprise financing at national, regional and international levels

29. As mentioned above, financing of the small- and medium-scale enterprise sector has to take into account a number of specific requirements and needs which are typical for the sector, resulting from the size or scale, the situation in which the units are operating, and the knowledge and experience of each and every individual entrepreneur.

30. In many developing countries, special programmes, institutions and agencies have been set up to look specifically at the problems of financing of the sector. In some of the countries it is not required since facilities exist in one form or other, whereas in other countries this problem has not yet been given the required priority. While in many countries special institutions and branches within developing banks or special teams within commercial banks have been established and the special window created for the small and medium enterprise sector and its particular problems, this trend has so far not been noticed at the regional level. Regional development banks or other such institutions have not yet paid special attention to the financing problematic of the small- and medium-scale enterprise sector.

31. The World Bank and its affiliates as well as national development banks of industrialized countries have established and carried out a large number of loan schemes and lines of credits for small- and medium-scale enterprises. Large amounts of their portfolio have gone into financing of those enterprises. These international institutions have opened a special informal window for the small- and medium-scale enterprise sector, but they have not yet created within their organization departments which specifically deal with a sector which will certainly gain more importance in the future.

Innovations in collateral requirements

32. Provision of security for loans is a major problem in the small- and medium-scale enterprise sector. It is not so much a question as to whether 100 per cent, 150 per cent or 200 per cent of the loan is required as value of the security, as to the general availability of security for a loan which creates difficulties for entrepreneurs. The core of the problem is the entrepreneur, a person with ideas and drive willing to earn a living through the enterprise but with no strong financial backing in the form of cash funds or values of other kind. The convential forms of security are land or other investments such as houses etc. Many entrepreneurs do not possess such property. Moreover, the situation is aggravated since in many countries land is often owned jointly by the family or by the eldest person in the family. In spite of the availability of land, it is not easily possible to obtain a title deed for the land in the name of the person applying for the loan. In other countries land ownership is not registered, and therefore onwnership cannot be proven in any written form.

33. Many financial institutions have started to accept the equipment purchased through the loan as guaranties for repayments. This principle should be generally applied with the exception of equipment which is small and of high value, such as expensive cameras for a photo studio, which can easily

be removed. Other collateral, for instance, for loans of imported raw materials are special warehouses to which only the entrepreneur and the bank have access. The bank controls the stock and only releases materials against agreement and payment for the portion required at the time.

34. Hire-purchase schemes are further instruments to release the burden of finding securities. Such schemes have operated in a number of countries with good results but are, of course, not the classic security arrangements for machinery and equipment bought on loan. Leasing of equipment offers similar solutions, but is not yet applied excessively by the small- and medium-scale enterprise sector.

35. While new ideas should be developed to ease the burden of providing securities to guarantee the repayment of loans to the small- and medium-scale enterprise sector, a waiving of any security should only be granted in very rare cases. The security offered, irrespective of its value, should be the mental tie and interest of entrepreneurs to utilize the loans productively. If the venture is a failure, the threat of losing one's property should be maintained as an incentive for operating an effective and profitable enterprise.

Availability and access to financial resources for venture capital

36. Venture capital for enterprises of the small- and medium-scale group is a relatively new requirement. It has emerged in the context of close links between research work, new technologies based mainly on electronic data processing and computerization on the one side and small- or medium-scale production on the other with the focus on transforming the results of research work into productive actions.

37. As governments are the main sponsors of research work, so are they also the most logic agents to provide resources for venture capital. A start has been made in research parks and innovation centres, often linked to universities. Thought should be given to provide funds and loans through special channels. Moreover, the possibility of equity participation of government-owned institutions in these enterprises should be considered.

Policy support systems and institutions to promote entrepreneurship among women

38. In the last decade participation of women in economic and business activities has been given high priority. Women have a natural talent for organization and management. They exercise and prove this daily in their family life which not only entails cooking and providing clothing and shelter etc., but also involves keeping the entire "enterprise" within the available budget. In the micro-enterprise sector and to some extent in small-scale enterprises, women entrepreneurs maintain a fairly large share which should be rewarded with payment of equal benefits as men. The non-financial services and institutions do not call for as many gender-specific measures as does the financial services sector. In general women receive equal treatment as their male competitors from development institutes, extension service centres or through applications for accommodation in industrial estates. Due to the nature and experience of women, there might be more demand for assistance from female entrepreneurs in engineering and technical matters, but no difficulties have been experienced in obtaining this type of services.

39. In some countries women entrepreneurs even dominate several sectors such as the retail trade, catering services, manufacturing in small-scale food and textile units or parts of the handicraft sector.

40. Difficulties, however, have been experienced by women entrepreneurs in receiving services from financing institutions. Major reasons for this can be found in the inability of women to provide guaranties for repayment of loans. Due to cultural or family traditions, the property of families is often in the name of the male partner within the family frame. Women entrepreneurs, therefore, face extreme difficulties in raising security as guaranty for loans. While economic and fiscal policies cannot change family traditions, thought should be given to finding innovative solutions and introducing specific measures focussing on improved access to financial sources for women entrepreneurs. These measures could also lie in introducing more training opportunities or easier acceptance of women in micro-enterprises or in directing them to those activities in the small-scale sector which will suit their talents and experience as business women in order to gain commercial experience and financial strength for larger enterprises at a later stage.

41. Women's World Banking as a non-governmental organization tries to create a more favourable climate for women entrepreneurs. The organization is expanding its activities in several countries, especially in Africa where the problem of women in finding institutional credits is more severe than on other continents. The creation of gender-specific organizations and intensified activities of Women's World Banking should be given favourable consideration.

Final consideration

42. Access to finance is a major problem for the small- and medium-scale enterprise sector. The Consultation may wish to examine the following key considerations with the view to reaching conclusions and recommendations for achieving an increased flow of funds to small- and medium-scale enterprises.

(a) Policies and mechanisms for increasing the volume of financial resources to small- and medium-scale enterprises

- Incentive and promotional measures to channel personal and community savings for productive investments;

- Establishment and expansion of rural banking facilities to act as financial intermediaries for industrial co-operatives and small- and medium-scale enterprises for their investment requirements in the framework of integrated rural development;

- Creation of special windows in financial institutions to provide funds at concessionary terms to small- and medium-scale enterprises in the context of programmes aimed at supporting private sector initiative;

- Promotion of policies that encourage the provision of special loan schemes, strengthening the operations of development banks and supporting the commercial banks through such instruments such as credit guarantee, re-discounting/re-financing schemes and foreign exchange risk.

(b) Improvement of access to finance institutions

- Differentiation of policies, incentive measures and instruments by target groups: micro-enterprises, industrial co-operatives and small- and medium-scale enterprises;

- Innovations in collateral requirements in accordance with the means and possibilities of the different target groups which could include for the most disadvantaged accepting collaterals as guarantee for loan repayments of land, equipment purchased through loans, and other securities for loans such as raw materials, contracts or personal guarantees.

- Reorientation and simplification of loan appraisal and approval procedures of the banking system through greater interaction and structured co-operation of own economic research and appraisal units with research and development institutes, technology centres, consulting engineering services in regard to market and technology viability and with chambers of commerce and industry, relevant communities and associations in regard to personal testimonials.

- Assistance in the identification, formulation and implementation of viable projects as well as in start-up, operations and marketing. Access to finance is critically dependent on the quality of project preparation and investment packaging. National institutions must accord high priority to this activity to increase the volume and access to financial resources. They should create consulting engineering services where these do not exist, establish close working arrangements with research and development institutes and technology centres, promote and implement training programmes for project personnel, and set up units for monitoring trends in markets and technology to facilitate the earliest entry of small- and medium-scale enterprises into new lines of production.

- Need for venture capital for entry into new investments based on inventions or innovations; government support in research and development, establishment of pilot projects, and provision of seed capital to set up manufacturing facilities;

- Joint ventures as instruments of investment packaging for locating high technology manufacturing facilities in co-operation with patent holders.

(c) Policy support systems and institutions to promote entrepreneurship among women

- Equal treatment of women entrepreneurs;

- Special provision of loan guaranties to women entrepreneurs;

- Assistance to organizations supporting women entrepreneurs.